Special Interest Session

Implementing forthcoming Revenue Recognition requirements

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Revenue from Contracts with Customers
Amsterdam, 27 June 2013

Agenda

- Background
- Summary of the model
- Advisor's perspective
At a glance

- Issue new Revenue Standard Q3
  - Joint Standard with FASB
  - Replaces IAS 18, IAS 11 and related Interpretations
- Framework for revenue recognition
- Effective date 1/1/2017, early application permitted
- Transition
  - Retrospective or
  - Cumulative effect at the date of application
- Revenue Implementation Group

Extensive due process

December 2008
Discussion Paper
Preliminary Views on Revenue Recognition in Contracts with Customers
211 comment letters

June 2010
Exposure Draft
Revenue from Contracts with Customers
974 comment letters
Roundtables

November 2011
Revised Exposure Draft
Re-exposure of Revenue from Contracts with Customers
358 comment letters
Roundtables

Q3 2013
Final Standard (IFRS)
IFRS X Revenue from Contracts with Customers
Effective date: 1 Jan 2017
Advisor’s perspective

- The proposed model
  - Addresses a range issues with the existing guidance
  - Provides better aligned principles
  - Improves the guidance in challenging areas
  - Facilitates consistency across a range of industries, geographies and standards
  - Includes a basis for conclusions
  - Provides a practical response to comments

Advisor’s perspective

- Areas of focus
  - More judgment required in a number of areas
  - Some of the principles might be clarified
  - Implementation questions
  - Letting go of industry guidance and thought processes
  - Role of interpretive guidance
  - Views and interpretations of regulators
  - Identifying application and other issues
  - Disclosure and transition
Scope

- All contracts with customers, except
  - Lease contracts
  - Insurance contracts
  - Financial instruments
  - Non-monetary exchanges in the same line of business to facilitate sales to customers

Main steps to apply Standard

1. Identify the contract with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognise revenue when (as) a performance obligation is satisfied
Step 1: Identify the contract

Existence of a contract
- Must meet specified criteria to apply the model

Combine contracts
- Negotiated as a package
- Linked consideration
- Goods or services form one performance obligation

Contract modifications
- Separate contract if add distinct goods/services at standalone selling price
- Prospective if remaining goods/services distinct
- Otherwise, cumulative catch-up

Step 2: Identify the performance obligations

Promise to transfer a distinct good or service
- On its own
- Together with other readily available goods or services (including goods or services previously acquired from entity)

Customer can benefit from good or service
- No significant service of integrating the good or service
- Good or service is not highly dependent on or interrelated with other goods or services

Promised good or service is separable from other promises
Step 3: Determine the transaction price

Amount of consideration to which entity expects to be entitled in exchange for goods or services

Variable consideration
Estimate using:
- Expected value
- Most likely amount but 'Constrained'

Significant financing
Adjust consideration if timing provides customer or entity with significant benefit of financing

Non-cash consideration
Measure at fair value unless cannot be reasonably estimated

Consideration payable to customer
Reduction of the TP unless in exchange for a distinct good or service

Step 3: Constraining variable consideration

Include estimate of variable consideration in the transaction price only if expect subsequent change to estimate would not result in a significant reversal of revenue

- Entity’s expectations of revenue reversal assessed using indicators, eg
  - Factors outside entity’s influence (market, 3rd-party actions)
  - Entity’s level of experience
  - Length of time before uncertainty resolved
Step 4: Allocate the transaction price

Allocate to each performance obligation the amount to which entity expects to be entitled in exchange for satisfying that performance obligation

- Relative standalone selling price basis
  - estimate selling prices if not observable
  - residual estimation techniques may be appropriate
- Discounts and contingent amounts allocated entirely to specific performance obligation if specified criteria met

Step 5: Recognise revenue when (as) a performance obligation is satisfied

Performance obligation is satisfied by transferring good or service

<table>
<thead>
<tr>
<th>Performance obligations satisfied over time if specified criteria met</th>
<th>All other performance obligations satisfied at a point in time</th>
</tr>
</thead>
</table>
| Revenue is recognised by measuring progress towards complete satisfaction of the performance obligation  
  - Clarified units produced or delivered may be a reasonable proxy in some cases  
  - Clarified input methods may need to be adjusted (eg uninstalled materials) | Revenue is recognised at the point in time when the customer obtains control of the promised asset. Indicators of control include:  
  - Present right to payment  
  - Legal title  
  - Physical possession  
  - Risks and rewards of ownership  
  - Customer acceptance |
Step 5: Performance obligations satisfied over time

A performance obligation is satisfied over time (ie revenue recognised over time) if one of three criteria met:

• The customer receives and consumes the benefits of the entity’s performance as the entity performs
  – assessed by considering (hypothetically) whether another entity would need to substantially re-perform the work completed to date if that other entity were to fulfil the remaining obligation

• The entity’s performance creates or enhances an asset (eg WIP) that the customer controls as the asset is created or enhanced

• The entity’s performance does not create an asset with an alternative use to the entity and the entity has a right to payment for performance completed to date, and it expects to fulfil the contract as promised

Disclosure requirements

User needs
Preparer concerns

Tentative decision: Clarifications and refinements to disclosure requirements
Disclosure requirements (continued)

**Disclosure objective:** To enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

**Disaggregation of revenue**

- **Disaggregate revenue into categories that depict how revenue and cash flows affected by economic factors**
  - When determining categories, consider: other disclosures, information reviewed by chief operating decision maker and other information used by entity.
  - Explain relationship with segment disclosures.

**Information about contract balances (formerly a reconciliation)**

- A combination of qualitative and quantitative disclosures
  - Opening and closing balances
  - Amount of revenue recognised from contract liabilities
  - Explanation of significant changes in contract balances

**Remaining performance obligations**

- Disclose aggregate amount of the transaction price allocated to remaining performance obligations.
- Quantitative or qualitative explanation of when amounts will be recognised as revenue.

**Interim requirements**

- IASB Disaggregation of revenue required in annual and interim financial statements; otherwise general principles of interim financial reporting apply.
- FASB All quantitative disclosures in annual and interim.
## Contract costs

<table>
<thead>
<tr>
<th>Costs of obtaining a contract</th>
<th>Costs of fulfilling a contract</th>
<th>Onerous contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognised as an asset if:</td>
<td>Recognised as an asset if:</td>
<td>Apply IAS 37</td>
</tr>
<tr>
<td>• Incremental</td>
<td>• Relate directly to a contract</td>
<td></td>
</tr>
<tr>
<td>• Expected to be recovered</td>
<td>• Relate to future performance</td>
<td></td>
</tr>
<tr>
<td><em>For example: Selling commissions</em></td>
<td>• Expected to be recovered</td>
<td></td>
</tr>
<tr>
<td></td>
<td><em>For example: Pre-contract or setup costs</em></td>
<td></td>
</tr>
</tbody>
</table>

## Implementation guidance: Licences

1. **Step 2: Identify the performance obligation(s)**
2. **Is the licence distinct?**
   - **No** — Account for bundle of goods and services
   - **Yes** — Apply criteria to determine whether licence:
     - transfers a **right** (ie a performance obligation satisfied at a point in time)
     - provides **access** to the entity’s intellectual property (ie a performance obligation satisfied over time)
## Transition, effective date and early application

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<tr>
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<tbody>
<tr>
<td>Contracts under new standard</td>
<td>Cumulative catch-up</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contracts restated</td>
<td></td>
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</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cumulative effect at date of application</th>
<th>Contracts not restated</th>
<th>Existing* and new contracts under new standard</th>
<th>Existing and new contracts presented under legacy IFRS/US GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cumulative catch-up</td>
<td></td>
<td></td>
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</table>

*contracts not completed in prior years as determined under legacy revenue guidance

- Effective date: annual reporting periods beginning on or after 1 January 2017
- Early application permitted (IFRS only)

## Revenue Implementation Group

- Public discussion to support initial application of the new Revenue Standard
- Will not issue authoritative guidance
- Limited life group
Revenue Implementation Group – Advisor’s Perspective

- Process for addressing issues identified by implementation
  - Interaction with regulators and local guidance
- Status of industry guidance
- Impact of early adoption
- Questions for the Implementation Group
  - How is the agenda set
  - What is the status of its conclusions
  - What is the due process and Board oversight
  - How does it interact with the IC and other groups
- Interpretations Committee
- Experience with other joint standards

More information

- Additional information about the revised proposals and the revenue recognition project is available at www.ifrs.org and www.fasb.org.
Thank you
Preparing the Implementation of IFRS 14 on Revenue Recognition

Dr. Christoph Hütten – SVP & Chief Accounting Officer, SAP
June 27, 2013

SAP’s Financial Reporting and Revenue Recognition History


- Going Public in Germany
- Going Public in the U.S.
- IFRS Mandatory in EU
- German GAAP
- US GAAP
- IFRS

SAP introduces industry specific US GAAP revenue recognition guidance (SOP 97-2) and adjusts certain business models to achieve a more favourable revenue recognition.

SAP establishes IFRS accounting policies „as close as possible to US GAAP” => SAP’s IFRS revenue recognition policies heavily US GAAP influenced.
SAP is a “Revenue Recognition-Driven” Company

Most arrangements are multi element arrangements

Delivery not always easy to determine or software

Highly variable software pricing due to low direct cost

High number of large deals with individualised contracts

The New Standard:
A Change in Mindset ... Rather than only an Accounting Change

SAP is under a very tight revenue recognition regime ... this may change

Example 1

<table>
<thead>
<tr>
<th>Under SAP's Current Policies</th>
<th>Under IFRS 14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocation of transaction fee to individual performance obligations based on Vendor Specific Objective Evidence of Fair Value (VSOE)</td>
<td>Allocation of transaction fee to individual performance obligations based on Estimated Standalone Sales Prices (ESP)</td>
</tr>
<tr>
<td>Frequent pricing changes over time may be a significant issue</td>
<td>Frequent pricing changes over time are less of an issue</td>
</tr>
</tbody>
</table>

Low pricing flexibility | High pricing flexibility |
The New Standard: A Change in Mindset ... Rather than only an Accounting Change

SAP is under a very tight revenue recognition regime ... this may change

Example 2

<table>
<thead>
<tr>
<th>Under SAP's Current Policies</th>
<th>Under IFRS 14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strict residual method due to lacking VSOE for software: Allocate amounts equalling VSOE to all elements other than software and residual to software</td>
<td>Full allocation of a discount to the triggering performance obligation may be appropriate even under residual approach</td>
</tr>
</tbody>
</table>

All discounts run against software revenue

Discounts triggered by a specific performance obligation may not affect “the residual”

The New Standard: A Change in Mindset ... Rather than only an Accounting Change

SAP uses revenue recognition to steer the business ... this may need to change

Example 3

<table>
<thead>
<tr>
<th>Under SAP's Current Policies</th>
<th>Under IFRS 14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocation of transaction fee to individual performance obligations based on VSOE High pricing consistency required to establish VSOE</td>
<td>Allocation of transaction fee to individual performance obligations based on Estimated Standalone Sales Prices (ESP) ESP deemed determinable even if pricing consistency is low</td>
</tr>
</tbody>
</table>

Strong incentive to focus on pricing consistency and to limit discounting on services

Weaker incentive to focus on pricing consistency because discounting of non-software deliverables has less of an impact
The New Standard: A Change in Mindset ... Rather than only an Accounting Change

SAP uses revenue recognition to steer the business ... this may need to change

Example 4

<table>
<thead>
<tr>
<th>Under SAP's Current Policies</th>
<th>Under IFRS 14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Due to lacking VSOE for software all revenue of a transaction is deferred if a future functionality is committed to the customer in a multi element arrangement.</td>
<td>Only amounts equal to the ESP of the future functionality are deferred if a future functionality qualifying as a separate performance obligation is committed to the customer in a multi element arrangement.</td>
</tr>
</tbody>
</table>

Strong incentive to refrain from committing future functionalities

Weaker incentive to refrain from committing future functionalities

Example 5

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<tr>
<th>Under SAP's Current Policies</th>
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<tr>
<td>All revenue from transactions may need to be deferred if significant customer payments are long overdue (rebuttable presumption that long overdue fees indicate high collectibility risk).</td>
<td>Collectibility risks are considered in expense rather than revenue.</td>
</tr>
</tbody>
</table>

Incentive for the sales force to support collection efforts

No incentive for sales force to support collection efforts (unless compensation framework is changed)
How We Prepare What is Coming

Aim
- Understand the proposals and their potential impact on SAP
- Actively participate in IASB Due Process to achieve a feasible outcome

Efforts
- Discuss proposals internally
- Discuss proposals with industry peers
- Discuss proposals with external auditor
- Comment on Discussion Papers and EDs (both alone and with industry peers)
- Liaise with IASB staff, IASB board members and national standard setter

How We Prepare What is Coming

Aim
- Understand the final standard and its impact on SAP
- Create awareness in the company
- Develop implementation strategy

Efforts
- Discuss final guidance internally and with industry peers to identify (a) required changes and (b) possible changes to business models, go-to-market models, accounting, internal controls, IT-systems, compensation models finance processes etc
- Align views on new proposals with external auditor
- Hold trainings for management and all internal stakeholders (accountants, other finance functions, sales force etc.)
- Decide on implementation strategy (“Minimize Differences” vs. “Use the Opportunity”) and transition approach
How We Prepare What is Coming

Aim
- Implement new guidance
- Optimise processes regarding efficiency & effectiveness

Efforts
- Re-write revenue recognition guideline and amend accounting guideline
- Hold trainings across the organisation
- Re-design / Adjust processes and IT systems and rollout the changes
- Adjust business models, go-to-market models, contracts internal controls, compensation models etc.
- Determine high level pro forma financial impact on prior periods
- Start executing and recording transactions under new guidance
- Prepare new disclosures

Thank you

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SAP
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